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In the Supreme Court of the United States

OCTOBER TERM, 1949

No. 445

BROWN SHOE COMPANY, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Tax Court of the United States (R. 23–26) is reported at 10 T. C. 291. The opinion of the Court of Appeals for the Eighth Circuit (R. 149–160) is reported at 175 F. 2d 305.

JURISDICTION

The judgment of the Court of Appeals was entered on June 17, 1949. (R. 161.) A petition for rehearing (R. 163–166)[1] was denied on Au-

[1] The petition was filed August 1, 1949 (R. 166), after the time for filing it had been extended to August 2, 1949, by the court below (R. 162).

gust 8, 1949 (R. 167). The petition for a writ of certiorari was filed on November 5, 1949, and was granted on January 9, 1950. (R. 168.) The jurisdiction of this Court rests upon 28 U. S. C. 1254.

QUESTIONS PRESENTED

The taxpayer received cash and property other than cash from certain community groups, in each case, for locating a new factory or enlarging an existing factory, and operating it, in the particular community. The questions presented are:

1. Whether the court below properly held that the taxpayer was not entitled, under Section 23 (l) of the Internal Revenue Code, to a deduction on account of depreciation of buildings and equipment to the extent that they were "contributed" to the taxpayer by, or acquired through the use of cash "contributions" from, the community groups.

2. Whether the court below properly held that the taxpayer was not entitled to include in its equity invested capital the cash and property other than cash received from the community groups, either as a "contribution to capital" under Section 718 (a) (1) and (2) of the Code, or as "accumulated earnings and profits as of the beginning of such taxable year" under Section 718 (a) (4) of the Code.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved are set out in the Appendix, *infra*, pp. 71–84.

STATEMENT

The facts, developed entirely by a stipulation between the parties (R. 27–34) and exhibits attached thereto (R. 35–123), were found by the Tax Court (R. 23–25). In so far as material here, they may be summarized, along the lines they were recited in the opinion of the court below (R. 149–151), as follows:

The taxpayer, Brown Shoe Company, Inc., the petitioner herein, is a New York corporation, having its principal place of business in St. Louis, Missouri. It filed its returns for the years here involved, the fiscal years ended October 31, 1942 and 1943, with the Collector of Internal Revenue for the First District of Missouri. (R. 27.)[2]

At all times material here, the taxpayer was engaged in the manufacture and sale of shoes and conducted its manufacturing operations in a number of different plants located in small towns in the States of Missouri, Illinois, Indiana and Tennessee. (R. 27–28.)

During the years 1914 to 1939, inclusive, citizens or "community groups" of 12 different towns "contributed" an aggregate amount of $885,559.45 in cash and $85,471.56 in property to the taxpayer for constructing a factory, or enlarging an existing factory, and operating it in the particular community. In each case, except one transaction

[2] This and other record references in the statement are made directly to the stipulation, rather than to the Tax Court's opinion.

involving only $10,000 in cash (R. 28), there was a written contract between the taxpayer and the community group. The contracts varied in some particulars, but generally required the taxpayer to construct or acquire a factory, or enlarge an existing one, in the particular community, to operate it for an agreed period of time, usually 10 years,[3] to employ a certain number of employees, and to meet a minimum stipulated pay roll during the period agreed upon. (R. 28–29, 35–109; see also R. 150.) The contract usually contained a provision to the effect that the cash to be paid to the taxpayer was to be "used for the payment of suitable factory building or buildings and equipment thereof" or that payment was to be made to the taxpayer "so that the same

[3] The taxpayer (Br. 3, fn. 2) states that four contracts "did not specify any period of time." However, the record shows that the four contracts referred to are in the nature of supplementary agreements with respect to the construction of an addition to a plant already constructed in a particular community pursuant to an original contract (R. 39, 69, 71–73, 99); that in three of those four cases the original contract, which is in the record, expressly provides for operation of the plant for a 10-year period (R. 37, 67, 97); that, in the case of the fourth, the original contract is not in the record, but, from the exhibit with respect to the addition to the plant, it may be reasonably inferred that the contract with respect to the original construction of the plant specified a 10-year period of operation (R. 71–73). In the light of the record, it seems reasonable to view the payments made for additions to existing plants in these four cases as at least entailing an obligation on the part of the taxpayer to continue the operation of the plant for the remainder of the 10-year period originally agreed to in each case.

shall be available for paying for the factory buildings and the equipment thereof as the work progresses thereon." (R. 150; see also R. 35, 49, 51, 65, 87.)

The contracts further provided that, in the event the taxpayer failed to comply with their terms, either the cash payments were to be refunded (R. 81), or the buildings were to be transferred to the communities (R. 37, 53, 61, 67, 77, 91, 97, 103, 105).[4] Upon compliance with the terms of the contracts, the taxpayer was to become free to operate the factories as it desired or dispose of them, and retain the proceeds without any obligation to account to the contributing groups. (R. 151.) The cash payments received by the taxpayer from the communities were not earmarked for, or held intact and applied against the cost of, the factory, machinery, equipment, or other items applicable to the plant acquired or constructed in the particular community. (R. 31.) The cash when received was deposited by the taxpayer in its general bank account and debited to cash on the debit side of its ledger, and credited to its "Earned Surplus Account" or, in some cases, first to "Contributed Surplus" and subsequently transferred to the "Earned Surplus Account." (R. 30, 151.) The value of the buildings received was set up in a

[4] The taxpayer (Br. 4) points out that in six instances the agreement with the community contained no obligation for the refunding of cash or transferring back of property. All six instances referred to are, however, agreements in connection with an addition or an extension of an existing factory. (R. 39, 41–47, 69, 71–73, 99, 108–109).

"Building Account" on the asset side of the taxpayer's ledger and thereafter carried as an asset.[3] (R. 30.) In every instance, the cash received by the taxpayer from community groups was less than the amounts expended by it for the acquisition or construction of the factory building and the machinery of such factory. (R. 31.)

In determining the amount of depreciation to be disallowed for the taxpayer's fiscal years ended October 31, 1942, and October 31, 1943, attributable to the assets acquired with contributed cash, the Commissioner first determined the total cost to the taxpayer of the factory building, the land (in cases where land was purchased by the taxpayer), and the machinery, and then allocated the cash contribution received by the taxpayer from the particular community to the cost of the building, land (in cases where land was acquired), and machinery in the ratio of the total cost of each of such items to the aggregate cost of all of them for the particular factory. (R 31–32.) The Commissioner disallowed deductions on account of depreciation claimed by the taxpayer with respect to the contributed property

[3] The value of the buildings received was stipulated as being $20,251.93 and $65,219.63, or a total of $85,471.56 (R. 28, [illegible] – which amounts have further been stipulated as the proper "bases" for depreciation and for inclusion in invested capital, if the taxpayer is entitled thereto (R. 32). Buildings were carried into the taxpayer's surplus account when received. (R. 111.)

(of a value aggregating $85,471.56) and buildings and machinery acquired with contributed funds (aggregating $885,559.45).* (R. 31.)

The Commissioner also disallowed the taxpayer's claim that the total amount of $971,031.01 of money and property contributed by the various communities was includable in its equity invested capital, and accordingly, in the computation of the taxpayer's excess profits tax liability for the fiscal years ended 1942 and 1943, reduced the taxpayer's invested capital by the amount of $971,031.01 for each year. (R. 14–15, 18–19, 31.)

The Tax Court affirmed the Commissioner's determination that the taxpayer was not entitled to depreciation on the property (other than cash) which had been contributed to it, and also sustained the Commissioner's determination with respect to the invested capital computation. (R. 24–25.) The Tax Court, however, reversed the Commissioner's determination in so far as he had disallowed the deductions for depreciation with respect to buildings and machinery acquired with contributed cash. (R. 25–26.) It gave as its reason the fact that the cash received by the taxpayer was deposited in its general checking account and was not "earmarked," and that therefore the taxpayer paid for the buildings and machinery out of

* The actual amount of disallowance on account of depreciation was $22,472.60 with respect to the fiscal year ended 1942 (R. 12–13), and $24,307.10 for the fiscal year ended 1943 (R. 16).

its own unrestricted funds. The Tax Court concluded that those buildings and machinery had a cost to the taxpayer, as shown on its books, and that the taxpayer was entitled to depreciation thereon. (R. 26.)

On the Commissioner's appeal, the court below reversed the Tax Court's decision as to the allowance of depreciation deductions with respect to buildings and machinery purchased with contributed cash (R. 152–155); on the taxpayer's appeal, the court below affirmed the decision of the Tax Court that the taxpayer was not entitled to depreciation on the property (other than cash) contributed to it, and affirmed the Tax Court's decision on the invested capital issue (R. 155–160).

SUMMARY OF ARGUMENT

I

A. *Detroit Edison Co.* v. *Commissioner,* 319 U. S. 98, disposes of the taxpayer's claim for depreciation deductions on buildings and equipment to the extent contributed to it, or acquired with cash contributed to it, by community groups, in each case as an inducement to operate a factory, or enlarge an existing one, in the particular community.

The taxpayer seeks the deductions on the theory that the cash and buildings it received were either "gifts", within the meaning of Section 113 (a) (2) of the Internal Revenue Code, or "contribu-

tions to capital", within the meaning of Section 113 (a) (8) (B) thereof so that its depreciation base would be that of the donor or transferor. Identical contentions were rejected by this Court in *Detroit Edison,* where the taxpayer had received payments from prospective customers upon applications for construction of line extensions, the Court holding squarely that the taxpayer was limited to *its own cost* as its basis for depreciation under Section 113 (a). The taxpayer's outlay, i. e., *its net investment* in the property, was held to be "the measure" of its "recoupment" through depreciation. From the fundamental principle that generally an investment in the property is a prerequisite to the allowance of depreciation deductions, it follows naturally that a taxpayer should not be allowed to recover an investment in property he has not made, where, as here, none of the exceptions to the general statutory rule applies. Therefore, the taxpayer here is not entitled to depreciation deductions on its buildings and equipment to the extent it has not borne their cost. If any doubt remained, it is dispelled by Section 113 (b) (1) (A), which would require that what was received by the taxpayer with respect to its buildings and equipment be charged against their cost as "receipts * * * properly chargeable to capital account". *Detroit Edison,* which is applicable and controlling here, requires affirmance on the depreciation issue.

B. The court below was correct in reversing, on the Commissioner's appeal, the Tax Court's erroneous conclusion that, in cases where the taxpayer had received cash, it was entitled to depreciation on the full cost of buildings and equipment because the cash was not "earmarked". That fact was not given any legal significance in the *Detroit Edison* case, and it was properly deemed not controlling by the court below.

C. There is no merit to the taxpayer's alternative claim that it is entitled to allocate some of the cash received to the costs of training new employees and of providing opening inventories. That was not the purpose for which the cash was paid over.

II

A. Affirmance is also required on the invested capital issue, because the taxpayer is not entitled, in the computation of its excess profits tax liability, to include in its "equity invested capital", either as a "contribution to capital" under Section 718 (a) (1) and (2) of the Code, or as "accumulated earnings and profits" at the beginning of each taxable year under Section 718 (a) (4), the cash and buildings it received from the communities.

B. As to the claim that the cash and buildings received are includible in equity invested capital as "contributions to capital" under Section 718 (a) (1) and (2), a complete answer is found in

the *Detroit Edison* decision since "contribution to capital" has the same meaning in Section 113 (a) (8) as it has in Section 718 (a) (1) and (2).

An independent analysis of Section 718 (a) (1) and (2) establishes that the cash and buildings received by the taxpayer are not includible in equity invested capital as "contributions to capital". In the computation, under the "invested capital" method, of the excess profits upon which the tax is imposed, Section 718 of the excess profits tax law of 1940, as properly interpreted, permits the inclusion in "equity invested capital" of the amounts "paid in" or invested by the shareholders in the business, in payment for their stock, as "paid-in surplus", or as a "contribution to capital", plus the amount of prior years' profits that have been allowed to remain invested in the business. The resultant amount, plus certain "borrowed capital", constitutes the base upon which the allowable non-taxed margin of profit is computed. Aside from the limited inclusion of "borrowed" capital, the law contemplates the allowance of a credit based exclusively upon what is *invested* in the business by the stockholders, consisting of what they have "paid in" and the prior profits they have left in the business. Only "money" or "property" originating from stockholders is includible in "equity invested capital" under Section 718 (a) (1) or (2) as "contribu-

tions to capital". The cash and buildings received by the taxpayer from the communities in question do not qualify for inclusion thereunder as "contributions to capital".

This conclusion is required by the plain terms of the statute and by its aim and purpose, particularly in the light of legislative history and principles established by applicable decisions—particularly decisions on the very same question under the First World War excess profits tax law, which, insofar as material here, was not different from the 1940 law. What is includible in equity invested capital under Section 718 of the 1940 law is limited to the items therein specified: It does not include all "working capital" or all assets used in the business. Under the correct concept of "capital", as the term is used in Section 718 (a) (1) and (2), capital consists only of a corporation's capital as such (i. e., the capital which is defined in its charter and paid in by its stockholders), and therefore there can be no "contribution to capital" unless there is a deficit therein, because contributions above that are necessarily "paid-in surplus". The two terms "paid-in surplus" and "contributions to capital" are merely correlative, "contributions to capital" having been developed and added, in the course of our income taxation experience, as the necessary complement of "paid-in surplus". Both terms necessarily relate exclusively to amounts paid in by shareholders, or possibly, as the Regulations

must have intended, by other persons having a proprietary interest in the corporation, such as the holder of some hybrid security, or even a bondholder.

C. The fundamental principle enacted into law in Section 115 (l) of the Code, and upheld in *Commissioner* v. *South Texas Co.*, 333 U. S. 496, and *Commissioner* v. *Wheeler*, 324 U. S. 542, disposes of the taxpayer's remaining contention, that the cash and buildings are includible in its "equity invested capital" under Section 718 (a) (4) as "accumulated earnings and profits" as of the beginning of each taxable year. Under that principle, gains which have not been recognized in the computation of income are not reflected in earnings and profits. Here, the buildings and cash, assumed not to constitute taxable income upon their receipt, are not includible in "accumulated earnings and profits".

ARGUMENT

I

The depreciation issue: The taxpayer is not entitled to deductions for depreciation during the taxable years on the "contributed" buildings or on the building and equipment acquired with "contributed" cash

A. The court below correctly held that the taxpayer was not entitled to the depreciation deductions

The taxpayer in this case sought, and the Commissioner disallowed, depreciation deductions on buildings and equipment to the extent that they had been "contributed" to taxpayer or acquired by

taxpayer with "contributed" cash. The court below held that the taxpayer was not entitled to the claimed deductions. (R. 152–155, 160.) Previously, in *Detroit Edison Co.* v. *Commissioner*, 319 U. S. 98, where a taxpayer had similarly claimed depreciation deductions on the portion of the cost of its properties which equalled the amounts its customers had paid towards their construction, this Court had held squarely that the "cost" of property under Section 113 (a) of the Revenue Act of 1936, c. 690, 49 Stat. 1648 (identical with Section 113 (a) of the Internal Revenue Code (Appendix, *infra*, pp. 72–73) means "cost to the taxpayer" (p. 102). This Court stated that "the taxpayer's outlay is the measure of his recoupment through depreciation accruals" (p. 102). It recognized there that a taxpayer must not be "permitted to recoup through untaxed depreciation accruals" (p. 103) an investment in property it has not made. It is submitted that the decision of the court below on the depreciation issue in this case properly follows the rule laid down by this Court in the *Detroit Edison* case, and is unquestionably correct—and that the decision on the similar depreciation question in *Commissioner* v. *McKay Products Corp.*, 178 F. 2d 639 (C. A. 3d), is clearly wrong.

It was because of the conflict caused by the *McKay Products* decision that the opposition to the application for the writ in this case was withdrawn by the Government. A petition for a writ has since been filed by the Government in the *McKay Products* case (No. 682, this Term).

Until the contrary decision of the Third Circuit in the *McKay Products* case, it had been uniformly held, in keeping with this Court's decision in the *Detroit Edison* case, that the basis for depreciation deductions on property in similar situations is the cost thereof to the taxpayer or, in other words, the taxpayer's "net investment" in the property, just as the court below held. See *Commissioner* v. *Arundel-Brooks Concrete Corp.*, 152 F. 2d 225 (C. A. 4th); *C. L. Downey Co.* v. *Commissioner*, 172 F. 2d 810 (C. A. 8th); see also *Lewis Jones, Inc.* v. *Commissioner*, 139 F. 2d 564 (C. A. 3d); *Reisinger* v. *Commissioner*, 144 F. 2d 475 (C. A. 2d).[8]

This Court had long ago laid down the principle that an investment in the property sought to be depreciated is a prerequisite to the allowance of a deduction for depreciation under a depreciation provision identical with that now contained in Section 23 (l) of the Code (Ap-

[8] While the Court of Appeals for the Third Circuit, in its opinion in the *McKay Products* case (pp. 643–644), regarded its decision in that case as not contrary to its earlier decision in *Commissioner* v. *Revere Land Co.*, 169 F. 2d 469, certiorari denied, 335 U. S. 853, we believe that it was clearly contrary to it. In the *Revere Land* case, the Third Circuit had held that the owner of the building, the Grant Company, was entitled to depreciation upon the entire cost of the building, even though it had received some money from the ground lessor, the Revere Company, because the Grant Company had "paid" for the money with the preferred stock it had issued (169 F. 2d at p. 482). It was because of that fact that the court in the *Revere* case distinguished that case from the *Detroit Edison* and *Arundel-Brooks* cases (pp. 482–483).

pendix, *infra*, p. 71). *Weiss* v. *Wiener*, 279 U. S. 333. That principle has been generally followed by lower courts. See *New York Cent. R. Co.* v. *Commissioner*, 79 F. 2d 247 (C. A. 2d), certiorari denied, 296 U. S. 653; *Tunnel R. R.* v. *Commissioner*, 61 F. 2d 166 (C. A. 8th), certiorari denied, 288 U. S. 604; *Belt Ry. Co.* v. *Commissioner*, 36 F. 2d 541 (C. A. D. C.), certiorari denied, 281 U. S. 742; see further *Detroit Edison Co.* v. *Commissioner*, 131 F. 2d 619, 622 (C. A. 6th), affirmed, 319 U. S. 98, and *Commissioner* v. *Revere Land Co.*, 169 F. 2d 469, certiorari denied, 335 U. S. 853.

The fact that the taxpayer's buildings and equipment, either contributed to it or acquired with contributed cash, are being used up in the business and "will in time wear out" and "must eventually be replaced" (cf. *Commissioner* v. *McKay Products Corp.*, 178 F. 2d 639, 643 (C. A. 3d)), does not entitle the taxpayer to a deduction for depreciation with respect thereto to the extent that the taxpayer has not borne their cost. The taxpayer, in so far as the buildings and equipment contributed to it or acquired with contributed cash are concerned, has made no capital investment on which it is presently suffering a loss. The mere fact that it will have to replace the properties does not suffice to give it a depreciable interest in the properties, in so far as contributed to it or acquired with contributed cash. *Weiss* v. *Wiener*, 279 U. S.

333. If, as, and when the taxpayer does replace the buildings and equipment and makes its own investment therein, it will then begin to suffer a loss thereon and will at that time become entitled to depreciation deductions to the extent of its investment, i. e., to the extent of the cost of the replacements. See *New York Cent. R. Co.* v. *Commissioner*, 79 F. 2d 247, 251 (C. A. 2d), certiorari denied, 296 U. S. 653; *Belt Ry. Co.* v. *Commissioner*, 36 F. 2d 541, 542 (C. A. D. C.), certiorari denied, 281 U. S. 742. But, in the taxable years here involved, the taxpayer (no replacement costs having yet been paid by it—at least insofar as material here) is entitled only to depreciation deductions limited to its own cost of its property under Section 113 (a), namely, zero with respect to the buildings donated to it, and, with respect to the other buildings and equipment, their cost *less* the amount of the cash contributed to it. This is clearly the result required under Section 113 (a), as interpreted by this Court in the *Detroit Edison* case. And, if any doubt remained about the matter, it is completely dispelled by the provision contained in Section 113 (b) (1) (A) (Appendix, *infra*, p. 73), which would clearly require that the contributions received by the taxpayer with respect to its buildings and equipment be charged against the cost thereof as "receipts * * * properly chargeable to capital account".

See *Detroit Edison Co.* v. *Commissioner*, 319 U. S. at p. 102, and 131 F. 2d at p. 622.

The decision of this Court in the *Detroit Edison* case is dispositive of the taxpayer's claim that it is entitled to depreciation deductions with respect to the buildings and equipment acquired with contributed cash, either under Section 113 (a) (2) or (8) of the Code (Appendix, *infra*, pp. 72–73). (Br. 55–62). In the *Detroit Edison* case, the taxpayer contended that the payments received by it from prospective customers upon applications for construction of line extensions constituted "gifts" within the meaning of Section 113 (a) (2) of the Revenue Act of 1936, c. 690, 49 Stat. 1648, or "contributions to capital" within the meaning of Section 113 (a) (8) (B) of that Act.[9] In that case, the taxpayer also relied upon Article 113 (a) (8)–1 of Treasury Regulations 94, promulgated under the Revenue Act of 1936, which provided that in the case of property acquired by a corporation after 1920 from a shareholder as "paid-in surplus, or from any person as a contribution to capital", the basis of the property in the hands of the corporation is the basis which the property would have in the hands of the transferor if the transfer had not been made.[10]

[9] These provisions are identical with the corresponding provisions of the Internal Revenue Code relied upon by the taxpayer here. (Br. 56–57.)

[10] The provision of the Regulations there relied upon is the same as the corresponding provision of Treasury Regulations 111, Section 29.113 (a) (8)–1 (Appendix, *infra*, pp. 81–82), as the taxpayer admits (Br. 24).

Those contentions were flatly rejected by this Court, which held the basis of the property to be the "cost to the taxpayer" (319 U. S. 98, 102).

There is no merit to the taxpayer's attempt (Br. 15–16, 60–62) to distinguish the *Detroit Edison* case from the present case on the ground that in that case the payments received by the company "were to the customer the price of the service" (319 U. S. 98, 103).[11] Exactly in the same sense that the payments received by the taxpayer in the *Detroit Edison* case were to the payor "the price of the service", the cash and the buildings received by the taxpayer in the instant case were to the communities (which paid or transferred them to the taxpayer) *the price* they paid to have the taxpayer operate the plant in the particular community, or enlarge an existing plant, for the period of time and under the conditions specified in the contract.

The comment that the payments "were to the customer the price of the service" was merely an observation made by this Court in *Detroit Edison* in connection with its general rejection of the contention that the payments received by the taxpayer there were either gifts or contributions to capital so as to make Section 113 (a) (2) or (8) applicable. It is true that neither there nor here were the payments received by the taxpayer in return for services rendered

[11] The Third Circuit made that erroneous distinction in the *McKay Products* case (178 F. 2d 639, 643).

or to be rendered *in the usual sense*. The payments were described as part of the "price" in an effort dramatically to distinguish them from gifts or contributions. As inducements, they were neither gifts nor contributions.

A deduction from gross income on account of depreciation of property is permitted by Section 23 (l) of the Code (Appendix, *infra*, p. 71), and Section 23 (n) (Appendix, *infra*, p. 71) provides that the "basis" for depreciation shall be as provided in Section 114. Section 114 (a) (Appendix, *infra*, p. 74) provides that the basis for depreciation shall be the "adjusted basis" provided in Section 113 (b) (Appendix, *infra*, pp. 73–74) for determining gain upon the sale of property, which in turn provides that the adjusted basis shall be the basis determined under Section 113 (a) (Appendix, *infra*, pp. 72–73) with certain adjustments set out in Section 113 (b). Amongst these adjustments is the one required to be made by Section 113 (b) (1) (A) (Appendix, *infra*, p. 73) for "expenditures, receipts, losses, or other items, properly chargeable to capital account". Section 113 (a) provides that the basis for property shall be the cost thereof, with certain exceptions, amongst which are the exceptions provided in Section 113 (a) (2), to the effect that if property was acquired by gift after 1920 its basis shall be the same as that of the donor, and in Section 113 (a) (8) (B), which is to the effect that if property was acquired as "paid-in surplus or as

a contribution to capital", the basis shall be the same as it would be in the hands of the transferor.

Consequently, the taxpayer here is not entitled to the depreciation deductions in question, because its measure for depreciation is limited to its cost, under Section 113 (a), and, as seen, *supra*, pp. 18–20, neither Section 113 (a) (2) nor Section 113 (a) (8) is applicable. Just as this Court said in the *Detroit Edison case* (319 U. S. 98, 102), it may also be said here that "it overtaxes imagination" to regard the communities which paid the cash or transferred the buildings to the taxpayer as the makers of gifts or contributions to the capital of the taxpayer. It may well be true, as the taxpayer asserts (Br. 60), that the "contributions" were made "voluntarily" and that the makers intended to transfer to the taxpayer an "economic benefit", but those elements cannot serve to transform the payments of cash or transfers of property into either gifts or contributions to capital of the taxpayer. It is obvious from the record that the transfers were not gratuitous and were not made with a donative intent, but were made with the expectation on the part of the communities of deriving benefits which would come from the taxpayer's performance of its undertaking to operate a plant in the community, or to enlarge an existing operation. The expected benefits must to the communities have seemed real and vital enough to warrant the making of the substantial payments here involved. The

benefits expected by the small communities in question must be regarded as substantial, in a very material sense—and not merely as an "intangible satisfaction", as the taxpayer suggests. (Br. 62.) The communities in question were not giving the taxpayer the buildings and cash "for nothing" (*cf. Commissioner* v. *Jacobson*, 336 U. S. 28)—as the "price" of their payments, they exacted the promise by the taxpayer to operate a plant in the community, or to enlarge an existing operation.[12] That constituted a valuable consideration, and, a valuable consideration being present, the transfers cannot possibly be regarded as "gifts". See *Detroit Edison Co.* v. *Commissioner*, 131 F. 2d 619, 622–623 (C. A. 6th); *Commissioner* v. *Montague*, 126 F. 2d 948, 951 (C. A. 6th); *Roberts* v. *Commissioner*, 176 F. 2d 221, 223 (C. A. 9th); *McKay Products Corp.* v. *Commissioner*, 9 T. C. 1082, 1092–1095, reversed, 178 F. 2d 639 (C. A. 3d). See also *Noel* v. *Parrott*, 15 F. 2d 669, 671 (C. A. 4th); *Botchford* v. *Commissioner*, 81 F. 2d 914, 916 (C. A. 9th); cf. *Bogardus* v. *Commissioner*, 302 U. S. 34, and *Helvering* v. *Amer. Dental Co.*, 318 U. S. 322.[13]

[12] See Section 86.8, Treasury Regulations 108, relating to the gift tax under the Internal Revenue Code, where it is stated that a "transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent)" will be considered as made for a full consideration, and hence not a gift.

[13] G. C. M. 16952, 1937–1 Cum. Bull. 133, relied upon by the taxpayer (Br. 27, 38), recognized that such transfers would

In varying situations, Congress has recognized that a taxpayer who has received property without paying for it and without taking it into income and paying an income tax thereon at the time of its receipt,[14] should not be allowed an annual deduction for depreciation of the property because no investment of his in the property is being used up. Where receipt free from income tax of gain or income has been permitted, Congress has at the same time required that no advantage be taken of that receipt in the "basis" for the property. This is demonstrated, for example, by amendments to the Code made by Section 215 of the Revenue Act of 1939, c. 247, 53 Stat. 862, whereby, in adding the provisions of Sections 22 (b) (9) and 113 (b) (3) to the Code, Congress "prescribed that, in order for a corporate taxpayer to exclude from its gross income under Section 22 (a) certain gains attributable to the discharge within the taxable year of the taxpayer's indebtedness evidenced by

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not be subject to the gift tax as "gifts". The question of whether such transfers can possibly be regarded as "contributions to capital" is further discussed in the second part of this argument.

[14] The record does not show specifically that the payments here were not taxed as income when received, but the taxpayer admits they were not (Br. 38), and both the court below and the Tax Court so assumed (R. 24, 158). That assumption was obviously warranted by the showing in the record that the contributions were either taken directly into the earned surplus account, or into contributed surplus and then transferred into the earned surplus account (R. 30, 113-114). Cf. *Edwards* v. *Cuba Railroad*, 268 U. S. 628.

bonds, the taxpayer must consent to the subsequent use of those gains in reducing the basis of property held by the taxpayer during any portion of the taxable year in which such discharge occurred". *Commissioner* v. *Jacobson*, 336 U. S. 28, 46. Another illustration is contained in the amendments made by Section 115 (a) and (b) of the Revenue Act of 1942, c. 619, 56 Stat. 798, whereby Congress, by adding Section 22 (b) (11) to the Code, permitted the exclusion from the gross income of a lessor of property, upon the termination of a lease, of the income attributable to improvements made by the lessee, while at the same time, by adding Section 113 (c) to the Code, it required that the lessor's basis for the property be not increased on account of the improvements made by the lessee which are excluded from income under Section 22 (b) (11). See H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 44, 69 (1942–2 Cum. Bull. 372, 408, 425–426); S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 78–79 (1942–2 Cum. Bull. 504, 564–565).[15]

B. On the Commissioner's appeal, the court below correctly reversed the conclusion of the Tax Court which erroneously gave controlling effect to the fact that the cash received by the taxpayer was not "earmarked"

The court below was correct in reversing (R. 152–155), upon the Commissioner's appeal, the

[15] These amendments to the Code came after it had been held in *Helvering* v. *Bruun*, 309 U. S. 461, that improvements made by the lessee constituted income to the lessor upon forfeiture of the lease.

erroneous conclusion of the Tax Court (R. 25–26) to the effect that the taxpayer was entitled to depreciation deductions based upon the full cost, as shown on its books, of the buildings and machinery with respect to which it had received cash contributions from the communities. The Tax Court, while recognizing the principle that the basis for depreciation of property is the cost to the taxpayer in holding that the Commissioner had not erred in disallowing depreciation on the contributed buildings (R. 25), reversed the Commissioner's determination in so far as he had disallowed depreciation deductions in respect of buildings and machinery acquired with contributed cash. That conclusion of the Tax Court as to the buildings and machinery acquired with contributed cash was based upon the significance which the Tax Court erroneously accorded to the fact that the cash received by the taxpayer "was not earmarked" (R. 25) for the particular purpose for which it had been contributed, and that the taxpayer paid for the buildings and machinery out of its own unrestricted funds.

The court below reversed on this point because it felt that the Tax Court had "committed a clear mistake of law and fact". (R. 154.) The action of the court below on this point was unquestionably correct, we submit, for the reasons given by it (R. 152–155) and because proper upon the record.

This is not, as the taxpayer claims (Br. 64), a situation where the trier of the facts has decided "to weigh more heavily" for one side, "in choosing between two permissible views of the weight of the evidence." It is not a case in which "the evidence would support a conclusion either way." *United States* v. *Yellow Cab Co.*, 338 U. S. 338, 342. Cf. *United States* v. *Gypsum Co.*, 333 U. S. 364, rehearing denied, 333 U. S. 869.[16] In this case, the Tax Court arrived at an erroneous conclusion with respect to the buildings and equipment acquired with contributed cash simply because it improperly accorded controlling legal significance to the fact that the cash received by the taxpayer was deposited in its general bank account and was not "earmarked". In *Detroit Edison*, the payments there received likewise went into the taxpayer's general funds and were not "earmarked". (319 U. S. 98, 100.)

C. The taxpayer's alternative claim for allocation of some of the cash received to the alleged costs of training new employees and of providing opening inventories is without merit

Taxpayer argues (Br. 65–66), in the alternative, that if the cost of buildings and machinery is to be reduced by the amount of cash received from the communities, then the cash contributions should also be allocated in part to the al-

[16] In this case there was neither a conflict in the evidence nor in the inferences reasonably to be drawn therefrom: The case simply presented a question as to the correct legal conclusions to be drawn from the undisputed, stipulated facts.

leged cost of training new employees and of providing opening inventories, instead of being allocated only to the cost of buildings, machinery and land (when land was acquired).

In support of this alternative contention, the taxpayer asserts (Br. 65) that the costs of training new employees and of opening inventories were stipulated. While it is true that it was stipulated (R. 33) that Exhibit 20–T (R. 119) shows those costs, the stipulation itself shows that the Commissioner questioned the correctness of the allocation reflected in that exhibit, in addition to objecting to its content as immaterial and irrelevant (R. 33). But the basic fallacy of the contention lies in the fact that, while taxpayer may have found it necessary to train new employees and to supply opening inventories (R. 32–33), it did not receive the cash payments for those purposes, nor was it in any case even authorized to use the cash it received for those purposes: All of the cash was given either specifically to be "used" for the payment of buildings or additions, and equipment, or was given as consideration for, on account of, or for the construction of buildings or additions, and equipment. (R. 35–99, 105–109.) The costs of training new employees and of opening inventories, whatever their amount, cannot possibly be related to the receipts from the communities; those costs were, as stipulated (R. 32–33), currently deducted by the tax-

payer and allowed by the Commissioner in computing the taxpayer's taxable income for the respective years in which they incurred. See Treasury Regulations 111, Sections 29.24–2, 29.41–1, 29.41–2 and 29.41–3. The contention that they should now enter into the allocation is so obviously without merit, we believe, that the court below was justified in not even passing upon it expressly in its opinion. (R. 149–160.) Though again brought to its attention by the taxpayer's petition for rehearing (R. 164), the court below merely denied the petition (R. 167), correctly, we submit.

II

The invested capital issue: The taxpayer is not entitled to include in its equity invested capital for the taxable years, either as a "contribution to capital" under Section 718 (a) (1) or (2) of the Code or as "accumulated earnings and profits" under Section 718 (a) (4) thereof, the cash and other property "contributed" to it by the communities

A. Preliminary

This invested capital issue arises under Section 718 of the Internal Revenue Code (Appendix, *infra*, pp. 80–81), which section is part of the new subchapter (SUBCHAPTER E—EXCESS PROFITS TAX) which was added to the Code by Section 201 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, entitled "Excess Profits Tax Act of 1940", applicable to taxable years beginning after December 31, 1939, and which was in effect repealed, as to taxable years begin-

ning after December 31, 1945, by Section 122 (a) of the Revenue Act of 1945, c. 453, 59 Stat. 556.

In that new subchapter, a tax was imposed by Section 710 (a) (Appendix, *infra*, p. 77) upon the "adjusted excess profits net income" as defined in Section 710 (b), namely, the "excess profits net income" as defined in Section 711, less the following: (1) A specific exemption of $5,000; (2) an excess profits credit computed under Section 712; and (3) an unused excess profits credit adjustment. Section 711 (Appendix, *infra*, p. 78) provides that the excess profits net income shall be the normal tax net income (as defined in Section 13 (a) (2) under Chapter 1 of the Code, relating to income tax), with certain adjustments.

Under Section 712 (a) (Appendix, *infra*, pp. 78–79) a corporation (if in existence prior to 1940) may take an excess profits credit computed either under Section 713 on the basis of average net income during the base period (the years 1936 to 1939), or under Section 714 upon the basis of invested capital, whichever results in the lesser tax.[17] By Section 714 (Appendix, *infra*, p. 79), a credit is granted equal to eight percent[18] of the taxpayer's invested capital, determined under Section 715. In Section 715 (Appendix, *infra*,

[17] The credit based on invested capital is the one taken by this taxpayer. (R. 14–16, 17–19.)

[18] This percentage was subsequently variously modified (see fn. to Section 714, Appendix, *infra*, p. 79).

p. 79) invested capital is defined as the average invested capital determined under Section 716, reduced by an amount computed under Section 720 relating to inadmissible assets. Section 716 (Appendix, *infra*, p. 80) sets up the formula for arriving at the average invested capital, namely, the aggregate of the daily invested capital divided by the number of days in the taxable year. Section 717 (Appendix, *infra*, p. 80) states that the daily invested capital shall be the equity invested capital plus borrowed invested capital determined under Section 719. Section 718 specifies what is to be included in equity invested capital and subsections (a) (1) and (2) thereof (Appendix, *infra*, pp. 80–81) provide for the inclusion in equity invested capital of money and property, respectively, previously paid "for stock, or as paid-in surplus, or as a contribution to capital", while subsection (a) (4) (Appendix, *infra*, p. 81) provides for the inclusion of "accumulated earnings and profits" as of the beginning of the taxable year.

Thus, Sections 710 to 720 deal with the determination of the excess profits net income upon which the tax is imposed, and hence may be generally regarded as the sections dealing with the "normal" provisions of the law. See *Premier Products Co.* v. *Commissioner*, 2 T. C. 445, 450. Then, under the new subchapter, after Section 720, come the sections dealing with "abnormalities" and special cases, which need not

be mentioned here. Looking at the excess profits tax law as a whole, it is apparent that the law taxes at high rates corporate profits above a certain level, computed either upon the basis of the income during a designated prior period or upon a percentage of invested capital—or, in other words, taxes "all corporate profits and gains over and above what Congress deemed to be a fair and normal return." *Commissioner v. South Texas Co.*, 333 U. S. 496, 497.

The taxpayer claims that it is entitled to include in its equity invested capital under the provisions of Section 718 (a) (1) and (2) as "contributions to capital", the amount of $971,031.01, constituting the total of the cash and buildings contributed to it by the communities (Br. 14–36), or, in the alternative, that it is entitled to include that amount in its equity invested capital under Section 718 (a) (4) as "accumulated earnings and profits", as of the beginning of each taxable year (Br. 36–55). The court below decided against the taxpayer on both contentions. (R. 155–160.)[19] It was correct in so doing.

[19] In *Commissioner* v. *McKay Products*, 178 F. 2d 639, the Court of Appeals for the Third Circuit decided, to the contrary, that property received by the taxpayer there from a community group was includible in equity invested capital as a "contribution to capital" under Section 718 (a) (2). No alternative contention that the property was also includible in equity invested capital as "accumulated earnings and profits" under Section 718 (a) (4) was made in that case, and therefore that point was not decided by the Third Circuit.

B. The cash and buildings received by the taxpayer are not includible in its equity invested capital as "contributions to capital" under Section 718 (a) (1) or (2)

(1) Since the cash and buildings are not "contributions to capital" under Section 113 (a) (8), they do not constitute "contributions to capital" under Section 718 (a) (1) or (2)

Since Section 728 of the Code (Appendix, *infra*, p. 81) provides that the terms used in the subchapter relating to the excess profits tax, of which Section 718 is a part, shall have the same meaning as when used in the chapter relating to the income tax, Chapter 1 of the Code, of which Section 113 (a) (8) is a part, the phrase "contribution to capital" has the same meaning in Section 718 (a) (1) and (2) as it has in Section 113 (a) (8).[20] Therefore, the decision of this Court in *Detroit Edison Co.* v. *Commissioner*, 319 U. S. 98, to the effect that the amounts received by the taxpayer there were not "contributions to capital" within the meaning of Section 113 (a) (8), unquestionably requires the conclusion that the payments received by the taxpayer here are not "contributions to capital" within the meaning of Section 718 (a) (1) or (2).[21]

[20] This is recognized by the taxpayer. (Br. 23.)

[21] Thus, *Detroit Edison* really disposes of the entire case, except the taxpayer's further claim that the contributions received by it are includible in equity invested capital as "accumulated earnings and profits" under Section 718 (a) (4).

(2) Even upon an independent examination of Section 718 (a) (1) and (2), the cash and buildings received by the taxpayer do not constitute "contributions to capital" thereunder

(a) *The plain meaning of the terms of the statute supports our position*

Under the excess profits tax law of 1940, the credit upon the invested capital method is based upon two factors, (1) the "equity invested capital" and (2) the "borrowed invested capital". In concept, equity invested capital is representative of an ownership or proprietary interest in the business, as distinguished from borrowed capital, which represents a creditor's interest in the business.

Equity invested capital under the statute is the amount invested in the business by the shareholders, plus the amount of earnings and profits that they have allowed to remain in the business. This is the plain meaning of Section 718, which, in substance, provides for the inclusion in equity invested capital of what the shareholders have originally paid in for their stock, plus what they have paid in as surplus or as contributions to capital, and, finally, plus whatever amount of profits of the operation in prior years they have allowed to remain invested in the business—with certain adjustments not here material. The words of Section 718 (a) (1) and (2) that are crucial here are "paid in * * * as a contri-

bution to capital". What is includible in equity invested capital necessarily relates exclusively to what is *paid in*, either in the form of cash or property other than cash, *by the stockholders* of the corporation—and not what may be *contributed to* the corporation by one who is not a stockholder. The use of the words "paid in" in both subsections (1) and (2) of Section 718 (a) clearly signifies an intent to refer only to money or property coming from stockholders. The expression "paid in" has a fixed and settled meaning and is used only to refer to what is "put in" a business by a person making an investment therein. Only an investor in a corporation, i. e., one who becomes a stockholder, *pays in* money or property to a corporation. Therefore the use of the term "paid in" clearly requires the conclusion that only money or property originating from *stockholders* can be included in equity invested capital under either subsection (1) or (2) of Section 718 (a). The correctness of this view is further demonstrated by an examination of Section 718 as a whole. For after the inclusion of the amounts originally paid in by stockholders for their stock and of the amounts paid in by them as "paid-in surplus" or "contributions to capital", equity invested capital is finally arrived at by making the additions and reductions prescribed in Section 718, with the obvious purpose and effect of allowing a credit upon the total of the amount invested by the

shareholders in the business and the amount of prior profits that have been allowed to remain invested in the business.

The correct concept of "capital" in our view, which the court below found to be supported by authority (R. 159–160), is that the term "capital" as used in Section 718 (a) (1) and (2) refers only to the corporation's capital as such, namely, to its capital as defined in its charter and paid in by its stockholders, and therefore there can be no "contribution to capital" unless a deficit therein exists, that is to say, unless there is an impairment of capital. This must be so because if there is no impairment to capital, then any contribution to a corporation must necessarily be to "paid-in surplus" within the meaning of Section 718 (a) (1) and (2).

The taxpayer criticizes this view, saying that it renders the term "contribution to capital" meaningless, because, it asserts (Br. 32), "the corporate taxpayer is expressly given the benefit of the money or property paid in for stock regardless of the time paid in and is not required to reduce that capital by any subsequent impairment." The criticism is without merit.

Contrary to the taxpayer's claim, it is only the concept of "capital" we have outlined as correct which permits the term "a contribution to capital" to have a meaning and a place of its own in the statute consistent with the general statu-

tory purpose to include in "invested capital" only amounts "risked" in the business by the owners. See *infra*, pp. 41–42, 49–56. The statute, in subsections (1) and (2) of Section 718 (a) provides for the inclusion in equity invested capital of money or property "previously paid in" in three manners: (1) "paid in * * * for stock"; (2) "paid in * * * as paid-in surplus"; and (3) "paid in * * * as a contribution to capital". With respect to "money", subsection (1) merely states that it be "previously paid in", while in the case of "property", subsection (2) contains the additional parenthetical provision that it be included "regardless of the time paid in". The parenthetical clause "regardless of the time paid in" applies to all three manners of paying in "property" permitted under subsection (2) to be included in equity invested capital. The clause "regardless of the time paid in" does not have the effect, suggested by the taxpayer (Br. 32), of making all property paid in, including that which is paid in as "paid-in surplus" or as "a contribution to capital", includible as, or under the classification of, "property paid in * * * for stock". The clause "regardless of the time paid in" appears in Section 718 (a) (2) merely as a necessary complement to the provision requiring that property be included at its "unadjusted basis"[22] so as to eliminate problems with

[22] This was a distinct departure from the First World War law, which required that property be taken in at its "value"

regard to March 1, 1913, valuations. (See Hearings before the Senate Committee on Finance, 76th Cong., 3d Sess., on H. R. 10413, p. 208.)

The result is that as to "property" the corporate taxpayer is not only "given the benefit" of "property paid in for stock regardless of the time paid in" (cf. taxpayer's brief, p. 32), but it is also given the benefit of property "paid in * * * as paid-in surplus" regardless of the time paid in, and of property "paid in * * * as a contribution to capital" regardless of the time paid in. The provisions for including property "paid in * * * as paid-in surplus" and property "paid in * * * as a contribution to capital" can, contrary to the taxpayer's assertion (Br. 32), have a separate meaning of their own under the statute when construed as reaching, over and above property "paid in * * * for stock," *additional* property, for which no stock is received, paid in as a "contribution to capital" where there is an impairment in capital, and paid in as "paid-in surplus" where there is no impairment to capital. The same is true, under subsection (1) with respect to "money" paid in.

The further reason given by the taxpayer (Br. 32) as a basis for its criticism of our view as to the concept of "capital," namely, that a tax-

(see the Memorandum prepared by the Treasury Department and submitted at the Joint Hearings before the House Ways and Means Committee and the Senate Finance Committee on Excess Profits Taxation, 76th Cong., 3d Sess. (August, 1940), p. 94).

payer is "not required to reduce that capital by any subsequent impairment," in our view supports, instead of conflicting with, the correct concept of "capital," as we have outlined it. For, the fact that the taxpayer is not required, in computing "equity invested capital", to reduce the amount of capital "paid in" by a subsequent impairment demonstrates that the statute recognizes the concept of "capital" as meaning the corporation's capital as such, namely, the capital as defined by its charter and paid in by its stockholders.

The taxpayer nonetheless argues that the cash and buildings it received, though not coming from stockholders, must be treated as "contributions to capital," within the meaning of Section 718 (a) (1) and (2), because Section 35.718-1 of Treasury Regulations 112 (Appendix, *infra*, pp. 82–83) contains the words "from any person" in referring to a "contribution to capital", while it refers to "paid-in surplus" as "from a shareholder". (Br. 25–26.)[23] The position taken is that, while "paid-in surplus" may come only from a shareholder, nevertheless under the Regulations, which taxpayer claims are binding (Br. 26), a "contri-

[23] The same provision was contained in the previous Treasury Regulations 109, in Section 30.718–1. Both excess profits tax regulations in this respect follow the wording of the previously existing Treasury Regulations under the income tax law, as they still appear in Section 29.113 (a) (8)–1 of Treasury Regulations 111 (Appendix, *infra*, pp. 81–82), as taxpayer points out. (Br. 24.)

bution to capital" may come "from any person". That contention must be examined in the light of what we have stated is the correct concept of "capital" as the term is used in Section 718 (a) (1) and (2).

Thus, in the instant case, since the taxpayer at all times material had accumulated earnings and profits in excess of the amount of $971,031.01 (R. 129), the cash and buildings received by the taxpayer would in any event be "paid-in surplus" and therefore, even under the Regulations relied upon by the taxpayer, they would not be includible in equity invested capital, since they did not come from stockholders.

But, beyond this, when examined in the light of what we have stated is the correct concept of the term "capital" used in the statute, the provision of the Regulations relied upon must be viewed as a recognition of the fact that while a contribution to "paid-in surplus" would necessarily come only from a shareholder, such as by his paying an amount in excess of par for his stock, on the other hand a "contribution to capital"—which means a contribution to the corporation's capital only insofar as there is a deficit therein, *i. e.*, one designed to wipe out a capital deficit—might be made by, in addition to a shareholder, some other person having a proprietary interest in the corporation, such as the holder of some hybrid security of the corporation which is not classifiable as stock, or perhaps even a bond-

holder.[24] Hence the use of the words "from any person" in referring to a "contribution to capital" in the Regulations must be regarded as made for the purpose of including, in addition to stockholders, other persons such as the holder of the hybrid security or the bondholder—but clearly cannot be construed also as including a person who has no proprietary interest whatever in the corporation.

(b) *So far as here pertinent, the 1940 excess profits tax law worked no change in the law as settled under the First World War excess profits tax law, and the decisions thereunder support our position.*

Under the First World War excess profits tax law, in Section 207 of the Revenue Act of 1917, c. 63, 40 Stat. 300, and in Section 326 of the Revenue Acts of 1918, c. 18, 40 Stat. 1057, and 1921, c. 136, 42 Stat. 227, invested capital was defined as including cash and property paid in to the corporation substantially in the same manner, insofar as here material, as "equity invested capital" was defined in Section 718 of the Code. See *Liberty Mirror Works* v. *Commissioner*, 3 T. C. 1018, 1024. The similarity was at least

[24] See Treasury Regulations 111, Section 29.24–2, in which it is stated "Amounts to be assessed and paid under an agreement between bondholders or shareholders of a corporation, to be used in a reorganization of the corporation, are investments of capital and not deductible for any purpose in returns of income. (See section 29.22 (a)–16.)" Cf. *Helvering* v. *Limestone Co.*, 315 U. S. 179, 184.

in general, recognized by this Court in *Commissioner* v. *South Texas Co.*, 333 U. S. 496. In passing upon invested capital under the old law this Court stated in *LaBelle Iron Works* v. *United States*, 256 U. S. 377, 387, 388:

> A scrutiny of the particular provisions of § 207 shows that it was the dominant purpose of Congress to place the peculiar burden of this tax upon the income of trades and businesses exceeding what was deemed a normally reasonable return upon the capital actually embarked. * * * When speaking of the capital of a business corporation or partnership, such as the act deals with, 'to invest' imports a laying out of money, or money's worth, either by an individual in acquiring an interest in the concern with a view to obtaining income or profit from the conduct of its business, or by the concern itself in aquiring something of permanent use in the business; in either case involving a conversion of wealth from one form into another suitable for employment in the making of the hoped-for gains. See Webster's New International Dict., "invest," 8; Century Dict. "invest," 7; Standard Dict., "invest," 1.

The Court further stated (pp. 389–390) that invested capital was to be "measured according to actual contributions made for stock * * * in order to confine the capital, the income from which was to be in part exempted from the burden of this special tax, to something approximately rep-

resentative of the risks accepted by the investors in embarking their means in the enterprise." See also *Ralston Steel Car Co.* v. *Commissioner,* 53 F. 2d 948 (C. A. 6th). Under the old excess profits tax law it had been expressly held that contributions by nonshareholders were not includible in invested capital. *Frank Holton & Co.* v. *Commissioner,* 10 B. T. A. 1317; *A. C. F. Gasoline Co.* v. *Commissioner,* 6 B. T. A. 1337; *Tampa Electric Co.* v. *Commissioner,* 12 B. T. A. 1002. The same conclusion has been reached—correctly—by the Tax Court in applying Section 718 (a) (1) or (2) of the Code in *McKay Products Corp.* v. *Commissioner,* 9 T. C. 1082, and the instant case.[25]

[25] Consistently, the amount of indebtedness of a corporation which is cancelled, has been held to be not includible in its equity invested capital if cancelled by a nonstockholder. *Liberty Mirror Works* v. *Commissioner,* 3 T. C. 1018; *Carlisle Tire & Rubber Co.* v. *Commissioner,* decided October 6, 1947 (1947 P-H T. C. Memorandum Decisions, ¶ 47,269), affirmed 168 F. 2d 816 (C. A. 3d); *Doylestown & Eastern Motor Coach Co.* v. *Commissioner,* 9 T. C. 846; *Walgreen, Inc.* v. *Commissioner,* decided March 30, 1948 (1948 P-H T. C. Memorandum Decisions, ¶ 48,042); cf. *George Hall Corp.* v. *Shaughnessy,* 67 F. Supp. 748 (N. D. N. Y.). On the other hand, the gratuitous forgiveness of a debt by a stockholder has been generally treated as a contribution to capital (see Section 29.22 (a)-13 of Treasury Regulations 111; *Carroll-McCreary Co.* v. *Commissioner,* 124 F. 2d 303 (C. A. 2d); *Commissioner* v. *Auto Strop Safety Razor Co.,* 74 F. 2d 226 (C. A. 2d); *Chenango Textile Corp.* v. *Commissioner,* 148 F. 2d 296 (C. A. 2d); *American Cigar Co.* v. *Commissioner,* 166 F. 2d 425 (C. A. 2d); *Gibson* v. *Commissioner,* 83 F. 2d 869 (C. A. 3d); cf. *Schweppe* v. *Commissioner,* 8 T. C. 1224, affirmed, 168 F. 2d 284 (C. A. 9th)), as have voluntary cash payments to a cor-

The taxpayer argues that the decisions under the First World War law are inapplicable because of the differences existing between that law and the 1940 law with respect to what is included in invested capital for the purpose of determining the amount of profits deemed to be excess. (Br. 17–22.) The differences pointed to are that, in addition to what was to be included in invested capital under the first law, the second law provided for the inclusion in invested capital of "contributions to capital" and "borrowed capital". The taxpayer argues (Br. 20) that the "inclusion of (1) borrowed capital and (2) a contribution to capital in the definition of invested capital under the later Act clearly negatives" any legislative intent to confine "invested capital" to that coming from stockholders. Neither of these differences supports the taxpayer's position here.

1. *The addition of the term "contribution to*

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poration by its shareholders (Section 29.22 (a)–16 of Treasury Regulations 111; *Jenkins* v. *Bitgood*, 101 F. 2d 17 (C. A. 2d), certiorari denied, 307 U. S. 636; *In re Park's Estate*, 58 F. 2d 965 (C. A. 2d), certiorari denied, 287 U. S. 645), and the voluntary surrender by shareholders of a portion of their stock (*Kistler* v. *Burnet*, 58 F. 2d 687 (C. A. D. C.); *Taylor* v. *McLaughlin*, 30 F. Supp. 19 (E. D. Pa.); *Murphy* v. *Commissioner*, decided July 28, 1945 (1945 P–H T. C. Memorandum Decisions, ¶ 45,259); *Scoville* v. *Commissioner*, 18 B. T. A. 261; *Haft* v. *Commissioner*, 20 B. T. A. 431; *Red Rock Petroleum Co.* v. *Commissioner*, 29 B. T. A. 118; and *Commissioner* v. *Hadley*, 75 F. 2d 485 (C. A. 2d).

capital".—In Section 207 of the Revenue Act of 1917, invested capital was defined as including the actual cash paid in for stock or shares, the actual cash value of tangible property other than cash paid in for stock or shares, and "paid in or earned surplus and undivided profits"; expressly excluded was "money or other property borrowed". The definitions of invested capital in Section 326 of the Revenue Acts of 1918 and 1921 were substantially the same as in the 1917 Act, except that the later Acts did not apply to partnerships, while the first Act applied to partnerships as well as corporations. It is true that the old law did not expressly use the term "contribution to capital" in defining invested capital. That omission may have been due to the fact that at that time the phrase "paid-in surplus" may have been thought broad enough to include both "paid-in surplus" and "contribution to capital" as the two concepts became subsequently established and were later separately used in our income tax law. See Articles 836 and 837 of Treasury Regulations 45 (1920 ed.). See also Article 813 of the same Regulations. The Treasury Department apparently regarded "contributions to capital" as having been includible in invested capital under the old law. See the Memorandum prepared by the Treasury Department and submitted at the Joint Hearings before the House Ways and Means Committee and the Senate Finance Committee on Excess Profits Taxation, 1940 (August, 1940), 76th Cong., 3d Sess., p. 94.

The addition of "contribution to capital" in specifying what is includible in equity invested capital under the 1940 Excess Profits Tax law merely reflects the later established separate meaning of that term and simply complements the inclusion of "paid-in surplus". The term "contribution to capital" first appeared in our revenue laws, as the taxpayer points out (Br. 23), in Section 113 (a) (8) of the Revenue Act of 1932, c. 209, 47 Stat. 169. That the term "contribution to capital" must be regarded merely as the necessary complement of the term "paid-in surplus"—under the correct concept of "capital" heretofore noted (*supra*, pp. 35–40)—that it simply was intended to reach contributions from stockholders which do not constitute "paid-in surplus" because of the existence of a deficit, and that both terms "paid-in surplus" and "contributions to capital" relate exclusively to *shareholders* is further demonstrated by the Committee Reports in connection with the passage of the Revenue Act of 1932. In H. Rep. No. 708, 72d Cong., 1st Sess., p. 21 (1939–1 Cum. Bull. (Part 2) 457, 471–472), the Ways and Means Committee of the House recommended the addition to the pre-existing Section 113 (a) (8) of a provision to insure the continuation of the long established position of the Treasury Department relative to the basis of property transferred to a corporation as "paid-in surplus"—it recommended adding in Section 113 (a) (8) (B) an express pro-

vision requiring the use of the transferor's basis in the case of property received as "paid-in surplus." The proposal was directly aimed at a *shareholder* situation—at a case of property transferred to a corporation by a *shareholder* as "paid-in surplus"—and it was made with the express intention of closing the avenue of avoidance which had but recently been opened by a Board of Tax Appeals decision.[26] The Senate Finance Committee, expressing the identical intention and aiming at the same case, agreed to the proposal and apparently merely to fill out or more fully carry out the purpose of the proposal, added to it a further provision requiring that property transferred to a corporation as a "contribution to capital" should also take the transferor's basis—*i. e.*, it changed the wording of the proposed provision so as to embrace specifically property transferred both as "paid-in surplus" and as "contributions to capital". S. Rep. No. 665, 72d Cong., 1st Sess., pp. 27–28 (1939–1 Cum. Bull. (Part 2) 496, 516.) The proposal, with the Senate amendment, was adopted in conference. H. Conference Rep. No. 1492, 72d Cong.,

[26] The decision referred to (H. Rep. No. 708, *supra*) was that of the Board of Tax Appeals in *Rosenbloom Finance Corp.* v. *Commissioner*, 24 B. T. A. 763, in which it was held that a corporation receiving property contributed to it by a stockholder was not limited to the transferor's basis. However, that decision was reversed on appeal. *Commissioner* v. *Rosenbloom Finance Corp.*, 66 F. 2d 556 (C. A. 3d), certiorari denied, 290 U. S. 692.

1st Sess., p. 13 (1939–1 Cum. Bull. (Part 2) 539, 542).

2. *The addition of "borrowed capital".*—The specific inclusion of borrowed capital in invested capital in the 1940 law indicates that Congress would have specifically provided for the inclusion of contributions by "nonstockholders" if that had been its purpose. While the First World War excess profits tax law excluded borrowed capital, in the 1940 law Congress provided for the inclusion in invested capital of 50 percent of borrowed capital, as defined in Section 719 of the Code. However, at the same time, Congress required by Section 711 (a) (2) (B) that an adjustment be made to income, whereby the deduction for interest is reduced by an amount equal to 50 percent of so much interest as represents interest on indebtedness which is included in borrowed capital under Section 719 (a). The reduction of the interest deduction by a percentage equal to the percentage in which borrowed capital is included in invested capital, so as to reduce the deduction for interest on indebtedness to the extent that that indebtedness goes into invested capital, was proposed in the very first Congressional report on the 1940 excess profits tax law, and thereafter adopted in all subsequent reports of Congressional committees. See Report of a Subcommittee of the Committee on Ways and Means, House of Representatives, 76th Cong., 3d Sess., p. 13, on Proposed Excess-Profits Tax-

ation (August 8, 1940); H. Rep. No. 2894, 76th Cong., 3d Sess., pp. 8, 19, 23 (1940–2 Cum. Bull. 496, 501, 510, 513); S. Rep. No. 2114, 76th Cong., 3d Sess., p. 11 (1940–2 Cum. Bull. 528, 536); and H. Conference Rep. No. 3002, 76th Cong., 3d Sess., p. 4 (1940–2 Cum. Bull. 548, 551). See also Joint Hearings, 1940, *supra*, pp. 70–74. Briefly, the effect of the provisions is that, to the extent to which an indebtedness is included in invested capital as borrowed capital under Section 719, the deduction from income of the interest thereon shall be proportionately reduced. The significance of the required adjustment to income is that, if borrowed capital is allowed to be treated as capital "invested" in the business for the purpose of arriving at the excess profits tax credit, then the interest which represents the cost of using that borrowed money (*Old Colony R. Co.*, v. *Commissioner*, 284 U. S. 552, 560), must be eliminated as a deduction—*i. e.*, if borrowed money is treated as invested in the business, then the cost of borrowing is not entitled to be deducted from income, since no interest would be paid if the money were actually invested.

Borrowed capital was included in the 1940 law for the purpose of aiding small concerns, which had to borrow money to raise additional capital, and for the purpose of encouraging expansion, for the contemplated defense program. See Joint Hearings, 1940, *supra*, pp. 70–72, 74. It was also included for the additional purpose of

eliminating difficulties experienced under the old excess profits law in cases in which "the tax became unduly high because of the exclusion of borrowed capital from invested capital" (Joint Hearings, 1940, *supra*, p. 95).[27] The addition of borrowed capital to the limited extent of 50 percent, instead of supporting the taxpayer's position, to the effect that equity invested capital under the 1940 law must not be limited to that coming from stockholders, supports the contrary view. From the limited inclusion of 50 percent of "borrowed capital" allowed, it seems reasonable to infer that Congress was willing to depart from the concept of "stockholders' capital" only to the extent of 50 percent, and only in cases where the addition to capital constituted an obligation of the business, for which the owners were incurring a risk. The "contributions" received by the taxpayer were not obligations of the business—the taxpayer had risked nothing in so far as those "contributions" were concerned.

(c) *The legislative history further supports our position*

Further analysis of the legislative history yields strong support for our position that "contribu-

[27] It was in part because of the inclusion in invested capital of borrowed capital that the provision for the special assessment was eliminated as unnecessary in the 1940 law. See Joint Hearings 1940, *supra*, p. 95; Report of Subcommittee, *supra*, pp. 8–9.

tions to capital" which are includible in equity invested capital, under Section 718 (a) (1) and (2), relate only to contributions by stockholders.

Pursuant to a resolution of Congress (Joint Hearings before the House Committee on Ways and Means and the Senate Finance Committee on Excess Profits Taxation, 76th Cong., 3d Sess. (August, 1940), pp. 68–69), the Treasury Department had presented a plan for an excess profits tax, which was based upon the invested capital method exclusively. The staff of the Joint Committee on Internal Revenue Taxation also proposed a plan, which differed from the Treasury plan mainly in allowing the average earnings in a prior period to be used as a credit in determining the excess profits (Joint Hearings, *supra*, p. 69). The subcommittee of the House Committee on Ways and Means combined the two plans, and recommended the enactment of a law providing for alternative methods of computing the excess profits to be subjected to the tax, one based upon the invested capital method and the other based upon the average earnings of a prior period. See Report of the Subcommittee of the Committee on Ways and Means, House of Representatives, 76th Cong., 3d Sess., p. 3. See also Joint Hearings, *supra*, p. 69. The combination of the two plans, after certain changes, is what was finally adopted as the Excess Profits Tax Act of 1940. The subcommittee, in its report, expressly recognized that the tax upon the in-

vested capital method "is based upon the amount of capital being risked by the taxpayer and contemplates a tax on all profits in excess of a stated percentage of return upon the taxpayer's investment". (Report of the Subcommittee, *supra*, p. 3.)

The First World War excess profits tax laws had been based upon the invested capital method exclusively.[28] When the report of the subcommittee was being considered at the Joint Hearings in 1940, the Assistant Secretary of the Treasury, during the course of his testimony at the Joint Hearings, *supra*, pp. 68–97, submitted a memorandum[29] prepared by the Treasury Department (Joint Hearings, pp. 94–95), explaining the undesirable features of the First World War excess profits tax law and pointing out how they had been eliminated in the 1940 proposal recommended by the subcommittee. An analysis thereof demonstrates conclusively that there was no change here material in the concept of what is includible in *invested* capital—which (because of the addition of "borrowed capital") was called "equity invested capital" in the 1940 law—and discloses nothing which could possibly support the

[28] Revenue Act of 1917, c. 63, 40 Stat. 300, Sections 200 to 214; Revenue Acts of 1918, c. 18, 40 Stat. 1057, and 1921, c. 136, 42 Stat. 227, Sections 300 to 337.

[29] The memorandum was entitled "Advantages of the Invested Capital Concept Contained in the Current Excess-Profits Tax Proposal Over the Invested Capital Concept Contained in the Revenue Act of 1918."

view that the 1940 law contemplated the inclusion in "equity invested capital" of anything other than what the stockholders had invested in the business, plus the prior profits left in the business."

That equity invested capital under the 1940 law consisted exclusively of the amount invested in the business by the stockholders, aside from borrowed capital, is demonstrated further by the report submitted by Senator La Follette, ranking minority member of the Senate Finance Committee, in which he stated in part as follows (S. Rep. No. 2114, Part 2, 76th Cong., 3d Sess., p. 12):

> Moreover, it must be observed that the only property which figures in the computation of invested capital for tax purposes is property received in return for corporate stock issued to acquire such property.
>
> * * * * *
>
> The invested capital method of computing excess profits thus seeks to determine as fairly as possible the actual dollars invested by the shareholders in the business and remaining at risk in the business. It is only on actual money actually risked that invested capital is based. * * * Since invested capital is based only upon what was originally paid into the business plus the earnings remaining at risk in the

[30] The two particular differences between the two laws, which the taxpayer claims exist (Br. 17–22), have been shown to be of no contrary significance here, under subpart (b) of this argument (*supra*, pp. 43–49).

> business, subsequent write-downs on the corporate books have no effect upon invested capital. * * *

The Court of Appeals for the Third Circuit in *Commissioner* v. *McKay Products Corp.*, 178 F. 2d 639, apparently referring to these statements by Senator La Follette, remarked that they "may or may not be taken to mean that contributions to capital can come only from stockholders for the purpose of the tax credit", and further stated that it is "not clear" whether the Senator is speaking of the bill which eventually was passed or of his own suggested amendment (178 F. 2d 639, 641). While the first comment may be said to be merely unjustified, the second comment by that court was clearly wrong, because the report shows beyond any doubt that the invested capital plan which Senator La Follette had proposed in his amendment was exactly the same as the invested capital method which was finally enacted into law. Senator La Follette had proposed an amendment using the invested capital method as the sole measure of excess profits (S. Rep. No. 2114, Part 2, 76th Cong., 3d Sess., p. 11), and eliminating the "average earnings method" (same report, p. 13) which, in combination with the invested capital method, had been adopted by the House. In his minority report, he attacked the bill recommended by the Senate Finance Committee for combining what he claimed were two conflicting theories of excess profits taxation, one based on

average earnings and the other based on invested capital, and pointed to several defects and complications of the "average earnings" and the combined methods, which he claimed would be eliminated if the invested capital method alone were adopted. (Same report, pp. 1–9.) Then he presented his arguments in favor of the invested capital method, together with a refutation of the arguments against it. (Same report, pp. 9–13.) In answering the charge of "complexities" made against the invested capital method, he pointed out that those stemmed from the First World War law which had permitted the value of property paid in for stock to determine invested capital, and stated that his amendment, like the Committee amendment (*i. e.*, like the bill as amended by the Finance Committee, and as finally adopted into law), uses "the tax cost of property paid in" for determining invested capital (p. 11). He further stated that (pp. 13–14):

> My amendment is patterned after the one which was adopted by the Senate 41 to 31 (but deleted in conference) during the debate on the First Revenue Act of 1940 last June. The new amendment, however, is improved in many respects to embody technical improvements contained in the invested capital method worked out by experts of the Treasury Department. As respects the method of computing invested capital, my amendment is similar in almost every detail to the method of ascertaining invested capital under the

committee amendment. The 8 percent credit allowed on such invested capital is also the same under my amendment and the committee amendment.

In comparing his previously offered amendment (*i. e.*, the one which had been adopted by the Senate during the debate on what became the Revenue Act of 1940, c. 419, 54 Stat. 516) with his new amendment (*i. e.*, the one he was reporting on in S. Rep. No. 2114, Part 2, *supra*), Senator La Follette further stated with respect to his new amendment (p. 15):

> Technical improvement of the original amendment has been made by accepting certain definitions and methods of computing invested capital, as provided in the House bill by the Treasury experts, i. e., the computation and definition of average invested capital, daily invested capital, equity invested capital, borrowed capital, etc.

From an examination of the minority report, it is clear beyond any doubt that the statements made therein with regard to the invested capital concept apply both to the amendment proposed by Senator La Follette as well as to the bill approved by the majority of the Senate Finance Committee, which finally became law. Those statements lend further support to our view that the concept of the "invested capital" method (called "invested capital" in the First World War law and "equity invested capital" in the 1940 law) is to measure the "excess profits" upon the basis (aside from

"borrowed capital") of what the shareholders paid into the corporation, plus the prior profits left in the business. See also Hearings before the Senate Finance Committee, Second Revenue Act of 1940, 76th Cong., 3d Sess. (September, 1940), pp. 197, 208.

(d) *Equity invested capital does not include all "working capital" or all assets used in the business*

The taxpayer makes the further argument (Br. 34–35), in effect, that "equity invested capital" should be construed as including all assets or all working capital, as the Third Circuit erroneously held in *Commissioner* v. *McKay Products*, 178 F. 2d 639, 642. In adopting this view that "equity invested capital" is really the same as the corporation's working capital, the Third Circuit concluded that what should control should be the fact that the property received from the community group there was a part of taxpayer's working capital being used in the business. Of course, the cash and properties received by the taxpayer here are part of the taxpayer's assets, used in the business, and in that sense are part of the taxpayer's "working" capital. The payments were undoubtedly additional assets of the business, and their receipt had the result of showing an increase on the assets side in the taxpayer's financial statement. However, what is included in equity invested capital under Section 718 is restricted to the items specified therein and,

as has been aptly stated, "under § 718, financial statement improvements do not as such augment equity invested capital * * *." *Walsh Holyoke Steam B. Wks.* v. *Commissioner*, 160 F. 2d 185, 188 (C. A. 1st).

The taxpayer's argument amounts to a suggestion that it would be penalizing (Br. 33) a taxpayer using the invested capital method not to permit it to use all working capital in arriving at its credit, while under the alternative method the credit based on income reflects the earnings produced by all assets used in the business and therefore is based upon all working capital. There is no discrimination or penalizing. Congress provided two methods of computing the credit, available in the alternative, and a taxpayer is free to use whichever results in the lesser tax. A taxpayer using the method based on invested capital must compute invested capital in the manner specified by Congress for that method, and cannot complain that under the other method other items are taken into account in the computation of the credit. In final analysis, the taxpayer is really claiming that all of the assets of the business or all working capital should be included under equity invested capital in computing the credit on the invested capital method, because the credit under the income method is based upon the earnings of all the assets. The simple answer is that Congress did not say so. If Congress had intended to so provide, it would have been a simple matter for it to have said so. There is nothing in

the statute or in the reports of the legislative committees to support such a view, or to indicate or even suggest that Congress intended to permit equity invested capital to be computed upon the basis of total assets or total working capital. See Report of Subcommittee (dated August 8, 1940), *supra*, pp. 3, 5, 6–8, 11–12; H. Rep. No. 2894, 76th Cong., 3d Sess., pp. 4–5, 10–11, 24–26 (1940–2 Cum. Bull. 496, 498–499, 503, 513–515); S. Rep. No. 2114, 76th Cong., 3d Sess., pp. 2, 4–5, 6, 14 (1940–2 Cum. Bull. 528, 529, 531, 532, 538–539); and H. Conference Rep. No. 3002, 76th Cong., 3d Sess., pp. 47, 48–49 (1940–2 Cum. Bull. 548, 553, 554–555).

The view that Congress, under the invested capital method, did not intend to allow a credit for all working capital or a credit based upon all of the assets used in the business, is further supported by the fact that the base period "income experience" of the taxpayer was eliminated from the computation of the credit under the invested capital method in the 1940 excess profits tax law. The bill originally passed by the House provided for the invested capital credit to be computed upon the percentage of invested capital which the average earnings during the base period bore to the average invested capital during that period. That provision was as recommended by the Treasury Department (Joint Hearings, *supra*, pp. 69, 70), by the Subcommittee (Report of Subcommittee, *supra*, p. 3) and by the House

Ways and Means Committee (H. Rep. No. 2894, 76th Cong., 3d Sess., pp. 4, 22 (1940–2 Cum. Bull. 496, 498, 512)). The Senate Committee, however, eliminated "base period income experience" from the invested capital method and substituted a provision for the allowance of a flat credit of eight percent of the invested capital for the taxable year alone, which was adopted in conference (see S. Rep. No. 2114, 76th Cong., 3d Sess., pp. 2, 4–5, 14 (1940–2 Cum. Bull. 528, 529, 538), and H. Conference Rep. No. 3002, 76th Cong., 3d Sess., pp. 48–49 (1940–2 Cum. Bull. 548, 554)).

The view that under the invested capital method as finally written into law Congress did not intend to allow a credit for all working capital or for all assets used in the business, is further supported by the formula adopted by Congress for the treatment of inadmissible assets under Section 720 of the Code. This section provides that the average invested capital be reduced by a percentage which is equal to the ratio of inadmissible assets to total assets. In explaining the provision, it was stated that inadmissible assets "are not deducted directly from the invested capital for the reason that the total of admissible and inadmissible assets is not ordinarily equal to the invested capital" (Report of Subcommittee, *supra*, p. 6). See also H. Rep. No. 2894, *supra*, pp. 26–27 (1940–2 Cum. Bull. 496, 515). Congress recognized, and indeed in-

tended that under the invested capital method the credit would not be based upon the total of all of the assets used in the business: It intended that the credit would be based only upon the amount of the aggregate of the items permitted to be included in equity invested capital under Section 718, plus the borrowed capital allowed to be included under Section 719—which aggregate amount it realized would generally be different from the total of all assets.

(c) *The underlying purpose of the law supports our position*

The particular purpose of the statutory provision involved in this issue must be kept in mind, and a conclusion which would frustrate the statutory purpose should be avoided. Cf. *United States* v. *Benedict*, 338 U. S. 692, 696. Here, the statutory provision in question is Section 718, which is a provision granting a credit from the excess profits tax based upon the amount of *equity* capital *invested* in the business venture. In other words, it is one of the provisions written into the law to "establish a measure by which the amount of profits which were 'excess' could be judged". *West Construction Co.* v. *Commissioner*, 7 T. C. 974, 978. See *Commissioner* v. *South Texas Co.*, 333 U. S. 496. See also Report of a Subcommittee of the Committee on Ways and Means, *supra*, pp. 3, 5. See also S. Rep. No. 2114, Part 2, *supra*, p. 12. The computation

of equity invested capital under Section 718 should be upon a realistic test. See *Liberty Mirror Works* v. *Commissioner,* 3 T. C. 1018; *Walsh Holyoke Steam B. Wks.* v. *Commissioner,* 160 F. 2d 185 (C. A. 1st). In this case, when the situation is viewed realistically, it may well be said that "it overtaxes imagination" to regard the community groups, or the persons who contributed cash to them, as making contributions to the "capital" of the taxpayer. See *Detroit Edison Co.* v. *Commissioner,* 319 U. S. 98, 102. Section 718 of the Code should not be construed in such a way as to give the extremely favorable tax result contended for by the taxpayer, unless clearly warranted by the language of the statute or by the underlying purpose of the invested capital credit allowed under the excess profits tax law. See *Walsh Holyoke Steam B. Wks.* v. *Commissioner, supra,* p. 188. Neither the language of Section 718 nor the underlying purpose of the invested capital credit warrants such a result.

C. The cash and buildings received by the taxpayer are not includible in its equity invested capital as "accumulated earnings and profits" under Section 718 (a) (4)

On the invested capital issue, the taxpayer makes the alternative contention (Br. 36–55) that the cash and buildings it received from the communities are includible in its equity invested capital under Section 718 (a) (4) as "accumulated earnings and profits" as of the beginning of the

taxable years here involved. This contention is inconsistent with its first contention that the cash and buildings are includible in invested capital as "contributions to capital" under Section 718 (a) (1) and (2). In arguing that the receipts are "contributions to capital" within the meaning of subsections (1) and (2) of Section 718 (a), the taxpayer is claiming that they came in through the route of the "capital," as contrasted to the "income" route, while in arguing that they constitute "accumulated earnings and profits" as of the beginning of the taxable years under subsection (4), the taxpayer is claiming that they have been received through the "income" route.

The alternative contention was correctly rejected by the court below. (R. 156–158.) It runs counter to the fundamental principle in our law of income taxation to the effect that gain which has not been recognized in the computation of net income does not affect "earnings and profits" for tax purposes. *Commissioner* v. *South Texas Co.*, 333 U. S. 496, and *Commissioner* v. *Wheeler*, 324 U. S. 542. See also *Butter-Nut Baking Co.* v. *Commissioner*, 3 T. C. 423, and *Federal Union Insurance Co.* v. *Commissioner*, 5 T. C. 374; cf. *Taylor-Wharton Iron & Steel Co.* v. *Commissioner*, 5 T. C. 768.

As the taxpayer agrees (Br. 39–40), the term "accumulated earnings and profits" used in Section 718 (a) (4) of the Code has the same meaning for the purpose of the excess profits tax as it

has for the purpose of the income tax: Section 728 of the Code and Section 35.718–2 of Treasury Regulations 112 (Appendix, *infra*, pp. 81, 83–84). Even prior to the decision of this Court in the *Wheeler* case, it was an established principle that the same method employed in computing and reporting gains for income tax purposes must be used in determining earnings and profits. See G. C. M. 2951, VII–1 Cum. Bull. 160 (1928); I. T. 3253, 1939–1 Cum. Bull. 178; *Helvering* v. *Alworth Trust*, 136 F. 2d 812 (C. A. 8th), certiorari denied, 320 U. S. 784; *Siegel* v. *Commissioner*, 29 B. T. A. 1289, 1293; *Neptune Meter Co.* v. *Price*, 98 F. 2d 76 (C. A. 2d); *Wells Fargo Bank & Union Trust Co.* v. *McLaughlin*, 78 F. 2d 934 (C. A. 9th), certiorari denied, 296 U. S. 638.

If any doubt remained that unrecognized gains or losses did not affect earnings and profits, it was removed by Section 115 (l) of the Code, as this Court recognized in the *Wheeler* case. For many years, the Commissioner had consistently taken the position that gains or losses which are not recognized for income tax purposes neither increase nor diminish earnings or profits, but, in view of certain adverse holdings,[31] Congress set the matter at rest in 1940 by adding subsection (l) to Section 115 of the Internal Revenue Code (Appendix, *infra*, pp. 75–76), by Section 501 of

[31] As appears from H. Rep. No. 2894, *supra*, one of the purposes of the amendment was to overrule the principle applied in the case of *Commissioner* v. *F. J. Young Corp.*, 103 F. 2d 137 (C. A. 3d), and similar holdings.

the Second Revenue Act of 1940. See H. Rep. No. 2894, 76th Cong., 3d Sess., p. 41 (1940–2 Cum. Bull. 496, 526–527).[32] Section 115 (l), after setting out the method for the computation of gain or loss from the sale of property by a corporation, provides that "Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made". Section 115 (l) is a clear expression of a Congressional intent to provide that gain will not affect earnings and profits until it has been recognized in the computation of net income. Without directly resting on Section 115 (l), the decision of this Court in the *Wheeler* case confirmed the principle above mentioned: The holding of the Court in the *Wheeler* case correlates not only the extent to which, but the time when, gain shall be brought into earnings and profits with the extent to which and the time when such gain enters into the computation of net income. This Court, in the *South Texas* case, gave effect to the purpose of Section 115 (l) and applied it directly.

[32] This is the same Act by which Congress added the excess profits tax provisions to the Code, and in H. Rep. No. 2894, *supra*, it was noted that the proposed amendment, to add subsection (l) to Section 115 of the Code, would also be important in determining equity invested capital for excess profits tax purposes.

The taxpayer has not taken the position that upon the receipt of the cash and buildings it realized taxable income, but on the contrary asserts (Br. 38) that the receipts were not taxed to it as income[33] in reliance upon G. C. M. 16952, 1937–1 Cum. Bull. 133.[34] Since they have not been taxed as income upon their receipt, the cash and buildings can no more affect earnings and profits consistently with the assumed taxless character of the transaction than could the realized but unrecognized gains in the *Wheeler* case, or the unrecognized gains on installment sales in the *South Texas* case. As held in the *Wheeler* case, the policy of the revenue laws requires the use of the same basis in determining gains and losses which are to be brought into "earnings and profits" as that used in determining the gains and losses which are to be brought into the income account for the corporation's income tax. Here, as we have seen under point I above, the basis for determining gain and for depreciation on the investments in property which the taxpayer has not

[33] As already noted, both the Tax Court (R. 24) and the court below (R. 158) assumed that the cash and buildings had not been taxed as income to the taxpayer upon their receipt.

[34] The view expressed in that memorandum was based upon *Edwards* v. *Cuba Railroad*, 268 U. S. 628, and certain Board of Tax Appeals decisions following it, such as *Frank Holton & Co.* v. *Commissioner*, 10 B. T. A. 1317. See also *Tampa Electric Co.* v. *Commissioner*, 12 B. T. A. 1002. Whether the *Cuba Railroad* case and its progeny represent a correct view of the law is a question that has not been put in issue by the parties to this case.

made is zero, and hence that is the basis for determining the amounts which may be included in "earnings and profits". Only at the time when, and to the extent that, the taxpayer realizes income from the buildings and equipment, either contributed to it or acquired with contributed cash, may the "earnings and profits" account be increased. *Commissioner* v. *South Texas Co.*, 333 U. S. 496. See also *Butter-Nut Baking Co.* v. *Commissioner*, 3 T. C. 423, and *Federal Union Insurance Co.* v. *Commissioner*, 5 T. C. 374; cf. *Taylor-Wharton Iron & Steel Co.* v. *Commissioner*, 5 T. C. 768.

The taxpayer argues that the *South Texas* case is inapplicable here, asserting (Br. 37–38, 39) that there is no "deferment of income" here, as there was in the *South Texas* case under Section 44 of the Internal Revenue Code. True, no installment sales under Section 44 are involved here, but the receipt of cash and property which had not been taken into income at the time received is, in substance, identical with the nonrecognition of the gains in the *South Texas* case.

The taxpayer argues that the payments and property it received from the communities were subject to distribution as earnings and profits, that such distribution would have constituted a taxable dividend, and that, therefore, the amount thereof is includible in its "accumulated earnings and profits". (Br. 50–54.) The argument, we believe, misses the real point involved, which is

not *whether* these receipts ever come into earnings and profits, but *when* they come into earnings and profits. In apparent reliance upon the decision in *Edwards* v. *Cuba Railroad*, 268 U. S. 628,[35] these receipts were not taken into income at the time of their original receipt. Thus, since under the *Detroit Edison* case no depreciation deductions are allowable on the properties (to the extent that the taxpayer has made no investment therein), an aliquot portion of them is in effect being taken into earnings and profits each year by reason of the fact that the income to be taken into earnings and profits is not reduced by a depreciation deduction. Consequently, by the end of their useful life, the entire amount of these properties will be reflected in accumulated earnings and profits.[36] On the other hand, if the taxpayer, instead of retaining them for their complete useful life, should sell the buildings or machinery at any prior time, then whatever is realized out of their sale will come into income at that time (since the entire amount would then be taxable as gain, the taxpayer's basis being zero) and will

[35] See *supra*, note 34, p. 65.

[36] The taxpayer asserts (Br. 55, 59) that it has been allowed depreciation deductions in the past years on the buildings it received and on the full cost of the buildings and equipment in the communities from which it received cash. The record is silent as to this, and also as to what, if any, effect such deductions might have had on its accumulated earnings and profits. The record merely shows that it had, at all times material to the issues in this case, accumulated earnings and profits in excess of the amount of $971,031.01. (R. 129.)

then enter into earnings and profits. *Commissioner* v. *South Texas Co.*, 333 U. S. 496.

The taxpayer points to the fact that the Regulations, in Section 29.115–3 of Treasury Regulations 111, provide for the inclusion in earnings and profits of items which are not taxable as income when received. (Br. 38.) That there are such items is immaterial to the present question. Such items are merely exceptions to the general rule that earnings and profits for tax purposes include only what has been taken into income, and the existence of such exceptions is not inconsistent with what we have stated is the correct concept of earnings and profits, since earnings and profits in the tax sense do not correspond exactly to taxable income, nor do they necessarily follow income in the accounting sense. *Commissioner* v. *Wheeler*, 324 U. S. 542. But, to qualify as "earnings and profits" it is necessary that the item in question at least be received as income, i. e., as gain or profit, even if, at the time, the gain is not recognized. Here, the receipts involved are not items that have been deemed received as income, but receipts which have been treated as not being taxable as income on the theory that they constituted reimbursement to the taxpayer "for capital expenditures", in reliance upon *Edwards* v. *Cuba Railroad*, 268 U. S. 628, 632.[*] (See *supra*, note 34, p. 65.)

[*] The same distinction is applicable to such cases as *Ayer* v. *Commissioner*, 12 B. T. A. 284; *Cummings* v. *Commis-*

The fact that the buildings and cash received by the taxpayer have been taken into the earned surplus account on the taxpayer's books (R. 30–31) and, as the taxpayer asserts (Br. 37), have at all times been reflected in its "surplus account on the liability side of its balance sheet" does not make them part of "accumulated earnings and profits" for tax purposes. Bookkeeping entries are not controlling in tax matters. *Helvering* v. *Midland Ins. Co.*, 300 U. S. 216; *Bazley* v. *Commissioner*, 331 U. S. 737; *Edwards* v. *Douglas*, 269 U. S. 204. Further, the fact that the reflection of the cash and buildings in "earnings and profits" on the taxpayer's books may have been in keeping with "established accounting principles", as the taxpayer suggests (Br. 39), is immaterial. As already stated, the computation of earnings and profits in the tax sense "does not necessarily follow corporate accounting concepts". *Commissioner* v. *Wheeler*, 324 U. S. 542, 546. See also *Commissioner* v. *Estate of Bedford*, 325 U. S. 283.

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sioner, 73 F. 2d 477 (C. A. 1st); *Schweppe* v. *Commissioner*, 8 T. C. 1224, affirmed, 168 F. 2d 284 (C. A. 9th), relied upon by the taxpayer in this connection. (Br. 43–47.) That items of *income* are part of earnings and profits is of no significance here. Likewise, whether gifts to a corporation may be included in earnings and profits, as the taxpayer argues (Br. 46, 47–48), is not material here: The taxpayer did not receive "gifts". See part I of Argument, *supra*. See also G. C. M. 16952, 1937–1 Cum. Bull. 133, and Section 86.8 of Treasury Regulations 108.

CONCLUSION

The decision of the court below is correct and should be affirmed.

Respectfully submitted,

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APPENDIX

INTERNAL REVENUE CODE

CHAPTER 1—INCOME TAX

* * * * * *

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * *

(l) [as amended by Section 121 (c) of the Revenue Act of 1942, c. 619, 56 Stat. 798 [37]] *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, * * *

* * * * * *

(n) *Basis for Depreciation and Depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

* * * * * *

(26 U. S. C. 1946 ed., Sec. 23.)

[37] By Section 121 (d) of the Revenue Act of 1942, the amendment to Section 23 (l) of the Code was made applicable to taxable years beginning after December 31, 1938.

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(2) *Gifts after December 31, 1920.*—If the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that for the purpose of determining loss the basis shall be the basis so determined or the fair market value of the property at the time of the gift, whichever is lower. * * *[1]

* * * * *

(4) *Gift or transfer in trust before January 1, 1921.*—If the property was acquired by gift or transfer in trust on or before December 31, 1920, the basis shall be the fair market value of such property at the time of such acquisition.

* * * * *

(8) *Property acquired by issuance of stock or as paid-in surplus.*—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112 (b) (5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or

[1] This section was amended by Section 143 (a) of the Revenue Act of 1942, effective for taxable years beginning after December 31, 1941, in a respect not material to this case.

(B) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

* * * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

(A) [as amended by Section 130 (b) of the Revenue Act of 1942, *supra*] For expenditures, receipts, losses, or other items, properly chargeable to capital account, but no such adjustment shall be made for taxes or other carrying charges for which deductions have been taken by the taxpayer in determining net income for the taxable year or prior taxable years;

* * * * *

(2) *Substituted basis.*—The term "substituted basis" as used in this subsection means a basis determined under any provision of subsection (a) of this section or under any corresponding provision of a prior income tax law, providing that the basis shall be determined—

(A) by reference to the basis in the hands of a transferor, donor, or grantor, or

(B) by reference to other property held at any time by the person for whom the basis is to be determined.

* * * * *

(26 U. S. C. 1946 ed., Sec. 113.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) *Basis for Depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property.

* * * * *

(26 U. S. C. 1946 ed., Sec. 114.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.[*]

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from

[*] Section 115 (a) and (b) was amended by Sections 166 and 186 of the Revenue Act of 1942, and Section 512 of the Revenue Act of 1943, in respects not here material.

the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

* * * * *

(h) *Effect on Earnings and Profits of Distributions of Stock.*—The distribution (whether before January 1, 1939, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities, of stock or securities in another corporation, or of property or money, shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities, property or money, was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934, 48 Stat. 712, or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

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[*] By Section 501 (b) of that Act, subsection (1) of Section 115 of the Code was made applicable to taxable years

* * * * *

(l) [as added by Section 501 (a), Second Revenue Act of 1940, c. 757, 54 Stat. 974 ¶] *Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-Free Distributions.*—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (a), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. * * *

* * * * *

(26 U. S. C. 1946 ed., Sec. 115.)

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beginning after December 31, 1938, and by Section 501 (c) it was made effective as to the Revenue Act of 1938 and any prior Revenue Act as if a part thereof at the time of its enactment.

CHAPTER 2—ADDITIONAL INCOME TAXES

* * * * *

SUBCHAPTER E—EXCESS PROFITS TAX

[As added by Section 201 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, which provided that the new subchapter may be cited as the "Excess Profits Tax Act of 1940"]

SEC. 710. IMPOSITION OF TAX.

(a) *Imposition.*—There shall be levied, collected, and paid, for each taxable year beginning after December 31, 1939, on the adjusted excess profits net income, as defined in subsection (b), of every corporation (except a corporation exempt under section 727) a tax as follows:

* * * * *

(b) *Definition of Adjusted Excess Profits Net Income.*—As used in this section, the term "adjusted excess profits net income" in the case of any taxable year means the excess profits net income (as defined in section 711) minus the sum of:

(1) *Specific exemption.*—A specific exemption of $5,000;

(2) *Excess profits credit.*—The amount of the excess profits credit allowed under section 712; and

(3) *Unused excess profits credit.*—* * *

(26 U. S. C. 1946 ed., Sec. 710.)

SEC. 711.—EXCESS PROFITS NET INCOME.

(a) *Taxable Years Beginning After December 31, 1939.*—The excess profits net income for any taxable year beginning after December 31, 1939, shall be the normal-tax net income, as defined in section 13 (a) (2), for such year except that the following adjustments shall be made:

(1) *Excess profits credit computed under income credit.*—If the excess profits credit is computed under section 713, the adjustments shall be as follows:

* * * * *

(2) *Excess profits credit computed under invested capital credit.*—If the excess profits credit is computed under section 714, the adjustments shall be as follows:

* * * * *

(26 U. S. C. 1946 ed., Sec. 711.)

SEC. 712 [as amended by Section 13 of the Excess Profits Tax Amendments of 1941, c. 10, 55 Stat. 17 *] EXCESS PROFITS CREDIT—ALLOWANCE.

(a) *Domestic Corporations.*—In the case of a domestic corporation which was in existence before January 1, 1940, the excess profits credit for any taxable year shall be an amount computed under section 713 or section 714, whichever amount results in the lesser tax under this subchapter for the taxable year for which the tax under this subchapter is being computed. In

* By Section 17 of the Excess Profits Tax Amendments of 1941 the amendments made by that Act were made effective as of the date of the enactment of the Excess Profits Tax Act of 1940.

the case of all other domestic corporations the excess profits credit for any taxable year shall be an amount computed under section 714. (For allowance of excess profits credit in case of certain reorganizations of corporations, see section 741.)

* * * * *

(26 U. S. C. 1946 ed., Sec. 712.)

SEC. 713. EXCESS PROFITS CREDIT—BASED ON INCOME.

* * * * *

(26 U. S. C. 1946 ed., Sec. 713.)

SEC. 714. EXCESS PROFITS CREDIT—BASED ON INVESTED CAPITAL.

The excess profits credit, for any taxable year, computed under this section, shall be an amount equal to 8 per centum of the taxpayer's invested capital for the taxable year, determined under section 715.[3]

(26 U. S. C. 1946 ed., Sec. 714.)

SEC. 715. DEFINITION OF INVESTED CAPITAL.

For the purposes of this subchapter the invested capital for any taxable year shall be the average invested capital for such year, determined under section 716, reduced by an amount computed under section 720 (relating to inadmissible assets). * * *

(26 U. S. C. 1946 ed., Sec. 715.)

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[3] The amount of the credit was variously modified, by reductions on a graduated basis, by amendments to Section 714 of the Code made, successively, by Section 201 (b) of the Revenue Act of 1941, Section 217 of the Revenue Act of 1942, and Section 205 of the Revenue Act of 1943.

SEC. 716. AVERAGE INVESTED CAPITAL.

The average invested capital for any taxable year shall be the aggregate of the daily invested capital for each day of such taxable year, divided by the number of days in such taxable year.

(26 U. S. C. 1946 ed., Sec. 716.)

SEC. 717. DAILY INVESTED CAPITAL.

The daily invested capital for any day of the taxable year shall be the sum of the equity invested capital for such day plus the borrowed invested capital for such day determined under section 719.

(26 U. S. C. 1946 ed., Sec. 717.)

SEC. 718. EQUITY INVESTED CAPITAL.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

(1) *Money paid in.*—Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;

(2) [as amended by Section 218 of the Revenue Act of 1942, *supra*] *Property paid in.*—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. If the property was disposed of before such taxable year, such basis shall be determined under the law applicable to the year of disposition, but without regard to the value of the property as of March 1, 1913. If the property

was disposed of before March 1, 1913, its basis shall be considered to be its fair market value at the time paid in. If the unadjusted basis of the property is a substituted basis, such basis shall be adjusted, with respect to the period before the property was paid in, by an amount equal to the adjustments proper under section 115 (l) for determining earnings and profits;

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(4) *Earnings and profits at beginning of year.*—The accumulated earnings and profits as of the beginning of such taxable year; * * *

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(26 U. S. C. 1946 ed., Sec. 718.)

SEC. 728. MEANING OF TERMS USED.

The terms used in this subchapter shall have the same meaning as when used in Chapter 1.

(26 U. S. C. 1946 ed., Sec. 728.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.113 (a) (8)-1. *Property Acquired by a Corporation After December 31, 1920.*—The acquisition of property by a corporation after December 31, 1917, by the issuance of its stock or securities may not fall within the provisions of section 113 (a) (7), because of the fact that the property was not acquired in connection with a reorganization. If, however the acquisition of such property occurred after December 31, 1920, and falls within the provisions of section 113 (a) (8), the limitations therein imposed upon the basis of such property are applicable.

In respect of property acquired by a corporation after December 31, 1920, from a shareholder as paid-in surplus, or from any person as a contribution to capital, the basis

of the property in the hands of the corporation is the basis which the property would have had in the hands of the transferor if the transfer had not been made. In the case of property acquired by a corporation after December 31, 1920, as a gift, the basis thereof shall be determined under section 113 (a) (2).

Similar provisions were contained in the previous Regulations relating to the income tax under the Internal Revenue Code, Treasury Regulations 103, in Section 19.113 (a) (8)–1.

Treasury Regulations 112, promulgated under the Internal Revenue Code:

> SEC. 35.718–1 *Determination of Daily Equity Invested Capital—Money and Property Paid in.*—The equity invested capital for any day is determined as of the beginning of such day. The basis or starting point is found in the amount of money and property previously paid in for stock, or as paid-in surplus, or as a contribution to capital. * * * For the purpose of determining equity invested capital, the amount of any property paid in is the unadjusted basis to the taxpayer for determining loss upon a sale or exchange under the law applicable to the taxable year for which the invested capital is being computed. * * *
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> If the property was acquired after December 31, 1920, by a corporation from a shareholder as paid-in surplus or from any person as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor if the transfer had not been made. (See section 113 (a) (8).) If so acquired prior to January 1, 1921, the

basis is the fair market value of the property at the time it was paid in. Where the basis is the transferor's basis, those adjustments shall be made to such basis with respect to the period before the property was paid in as are proper under section 115 (l) for determining earnings and profits. Thus, if A paid into a corporation in 1930 as paid-in surplus certain improved real estate purchased by him in 1920 for $20,000, with respect to which depreciation was allowed for the period held by him in amounts aggregating $6,000 (the full amount allowable), A's basis of $20,000 shall be reduced by $6,000 for the purpose of computing the invested capital of the corporation.

* * * * *

SEC. 35.718–2 *Determination of Daily Equity Invested Capital—Accumulated Earnings and Profits.*—(*a*) *In general.*—The term "accumulated earnings and profits" is not defined in the Internal Revenue Code. See, however, section 115 and the regulations prescribed thereunder as to the effect of certain transactions on earnings and profits, and section 35.718–5 as to the effect of the declaration and distribution of dividends. In general, the concept of "accumulated earnings and profits" for the purpose of the excess profits tax is the same as for the purpose of the income tax. As to determination of additional amount to be included in daily equity invested capital on account of new capital, see section 35.718–4. In computing accumulated earnings and profits as of the beginning of the taxable year, a taxpayer keeping its books and making its income tax returns on the accrual basis shall subtract the income and excess profits taxes for the preceding taxable year. If there is a deficit in the

accumulated earnings and profits as of the beginning of the taxable year, such deficit shall not be taken into account in determining invested capital, and in such cases the earnings and profits as of the beginning of the taxable year shall be considered as zero, but subsequent earnings and profits shall be applied against such deficit. Unrealized appreciation in value of property is not a factor in determining earnings and profits.

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Similar provisions were contained in the previous Regulations relating to the excess profits tax under the Internal Revenue Code, as amended, Treasury Regulations 109, in Sections 30.718–1 and 30.718–2.

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